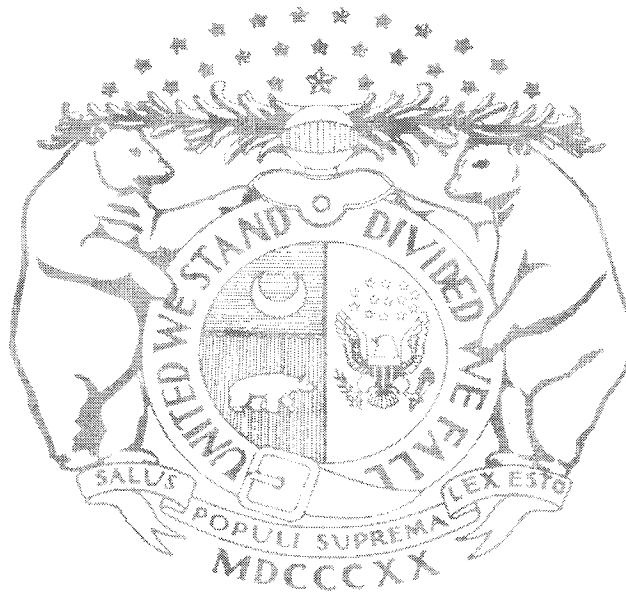


REPORT OF
FINANCIAL EXAMINATION

MISSOURI EMPLOYERS
MUTUAL INSURANCE COMPANY

AS OF
December 31, 2004



STATE OF MISSOURI
DEPARTMENT OF INSURANCE
JEFFERSON CITY, MISSOURI

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September 29, 2005
Columbia, Missouri

Honorable Kevin M. McCarty, Commissioner
Office of Insurance Regulation
Florida Department of Insurance
Chairperson, Financial Condition (E) Committee, NAIC

Honorable Jorge Gomez, Commissioner
Office of Commissioner of Insurance
State of Wisconsin
Secretary, Midwestern Zone, NAIC

Honorable W. Dale Finke, Director
Missouri Department of Insurance
301 West High Street, Room 530
Jefferson City, Missouri 65101

Gentlemen:

In accordance with your financial examination warrant, a full scope association financial examination has been made of the records, affairs and financial condition of

MISSOURI EMPLOYERS MUTUAL INSURANCE COMPANY

also referred to as the "Company." The Company's administrative office is at 1000 West Nifong Boulevard, Columbia, Missouri 65203, telephone number (573) 499-9714. This examination began on May 2, 2005, and concluded September 29, 2005.

SCOPE OF EXAMINATION

Period Covered

The prior financial examination of Missouri Employers Mutual Insurance Company was as of December 31, 2001, and was conducted by examiners from the state of Missouri, representing the Midwestern Zone of the National Association of Insurance Commissioners (NAIC).

The current full scope association financial examination covers the period from January 1, 2002 to December 31, 2004 and was conducted by examiners from the state of Missouri representing the Midwestern Zone of the NAIC. Reserves and related actuarial items were reviewed by the consulting actuarial firm of Expert Actuarial Services, LLC pursuant to a contract with the Missouri Department of Insurance.

This examination also included material transactions and/or events occurring after December 31, 2004.

Procedures

This examination was conducted using the guidelines set forth in the Financial Condition Examiners Handbook of the NAIC, except where practices, procedures and applicable regulations of the Missouri Department of Insurance and statutes of the state of Missouri prevailed.

The workpapers of the Company's independent auditors for 2004 were made available to the examiners. Standard examination procedures were modified as deemed appropriate under the circumstances.

Comments – Previous Examination

The general comments and recommendations in the previous examination report and the Company's response and/or subsequent action taken by the Company are listed below.

Comment:

The Company should continue to control premium growth through tight underwriting and pricing for a reasonable loss ratio in each market size category. At December 31, 2005 the Company must comply with all the statutory financial requirements for an insurance company and be subject to the implementation of all available financial tools, such as the "Premium to Surplus Ratio," to judge whether the Company is in a financial condition which would require further scrutiny by the Director. The premium to surplus ratio should be in the 3 to 1 range at December 31, 2005.

It is recommended that the Company continue to focus on its statutory mandate giving preference to Missouri employers that develop an annual premium of not greater than ten thousand dollars, noting that it is this segment of the market that has provided the Company its lowest loss ratios.

Company's Response:

We are in concurrence with the "general comments and recommendations" discussed on pages 38 and 39 of the examination report. In fact, we feel that the Department's recommendations are a strong confirmation of the Company's 2003 Operating Plan presented to, and approved by, our Board of Directors. Furthermore, our longer-term strategic plan is also in harmony with the explicit and implicit recommendations outlined in the examination report. The Company's 2003-2005 Strategic Plan projects a net premium to surplus ratio of approximately 2.4 to 1 prior to the expiration of the current order on December 31, 2005. We believe that we have developed, and implemented, strategic and operational initiatives that make this financial growth and stability feasible.

Actual results in the first quarter of 2003 confirm that the Company is moving in the right direction consistent with the recommendations from the Department. Overall exposure, measured by payroll of insured policyholders, has decreased by roughly 8% during the quarter and gross earned premium revenue is approximately 1% below 2003 Operating Plan projections. Perhaps more importantly, gross and net loss ratios have improved significantly from prior periods in all market size categories. In summary, the Company's plans to reduce overall exposure, price appropriately and increase underwriting selectively are working.

Current Findings:

Selected financial data as reported by the NAIC for the years 2001 to 2004 and the six months ending June 30, 2005 were as follows (in thousands):

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Surplus	11,694	27,090	44,954	83,304	89,534
RBC Ratio	116.2	156.3	296.5	648.7	NA
Underwriting Gain (Loss)	(13,160)	14,800	6,238	7,461	984
Net Income (Loss)	(6,588)	21,269	17,547	14,428	4,903
Loss Ratio	86.7	66.9	68.6	62.8	67.9
Expense Ratio	23.5	22.7	26.2	32.8	30.3
Combined Ratio	110.2	89.6	94.8	95.6	98.2
Gross Premium Written (GPW)	139,899	174,573	171,220	156,871	71,873
Net Premium Written (NPW)	126,049	160,003	149,370	137,219	66,382
GPW / Surplus	11.96	6.44	3.81	1.88	1.67
NPW / Surplus	10.78	5.91	3.32	1.65	1.50

HISTORY

General

The Company was created under Sections 287.900 to 287.920 RSMo (Missouri Employers Mutual Insurance Company Act) as an independent public corporation for the purpose of insuring Missouri employers against liability for workers' compensation, occupational disease and employers' liability. Pursuant to the Act, the Company is organized and operates as a domestic mutual insurance company and is not a state agency. The Company has the powers granted a general not for profit corporation pursuant to Section 355.131 RSMo (Duration, Succession – General Powers) to the extent such provisions do not conflict with the Missouri Employers Mutual Insurance Company Act.

The Company was incorporated on September 16, 1994 issued a Certificate of Authority on December 30, 1994 and commenced business on March 1, 1995.

Capital Stock

The Company is organized as a mutual insurance company and is not authorized to issue capital stock.

Dividends

The Company has never paid any dividends to policyholders.

Management

The Board of Directors consists of five members duly elected at an annual meeting of the policyholders as authorized by the Company's Articles of Incorporation. The directors duly elected and serving as of December 31, 2004 were as follows:

<u>Name</u>	<u>Principal Occupation</u>
Andrew R. Gingrich Columbia, Missouri	Chief Financial Officer and Treasurer MBS Textbook Exchange, Inc.
James J. Jura Springfield, Missouri	Chief Executive Officer Associated Electric Cooperative
Bob L. McDonald Sedalia, Missouri	Chairman Emeritus Third National Bank
Douglas D. Morgan Florissant, Missouri	President Self Storage Systems, Inc.
Albert A. Riederer Kansas City, Missouri	Attorney Riederer Law Offices

Members of the Committees of the Board of Directors as of December 31, 2004 were as follows:

<u>Audit Committee</u>	<u>Compensation Committee</u>	<u>Investment Committee</u>	<u>Real Estate Committee</u>
Andrew R. Gingrich	James J. Jura	Andrew R. Gingrich	Douglas D. Morgan
James J. Jura	Bob L. McDonald	James J. Jura	Andrew R. Gingrich
Douglas D. Morgan	Douglas D. Morgan	Bob L. McDonald	Bob L. McDonald
		Douglas D. Morgan	Albert A. Riederer
			James J. Jura

The officers elected and serving as of December 31, 2004 were as follows:

<u>Name</u>	<u>Office</u>
Albert A. Riederer	Chairman of the Board of Directors
Dennis W. Smith	President and Chief Executive Officer
Bob L. McDonald	Secretary
Andrew R. Gingrich	Treasurer and Assistant Secretary
Dina S. Schultz	Vice President and Chief Operating Officer
Dale K. Newton	Vice President and Chief Financial Officer
Rodney C. Smith	Vice President
Timothy D. Jackman	Vice President
Steve D. Millikan	Vice President

Conflict of Interest

Conflict of Interest Disclosure Statements are executed annually by all directors and officers of the Company. A review of the statements for the years under examination indicated no material conflicts that had not previously been disclosed to the Board of Directors.

Corporate Records

A review was made of the Articles of Incorporation and Bylaws of the Company. Neither the Articles of Incorporation nor the Bylaws were amended during the period being examined.

The minutes of the meetings of the Policyholders and Board of Directors were also reviewed for the period under examination. The minutes appeared to properly document and approve applicable corporate events and transactions.

Acquisitions, Mergers, and Major Corporate Events

None.

Surplus Debentures

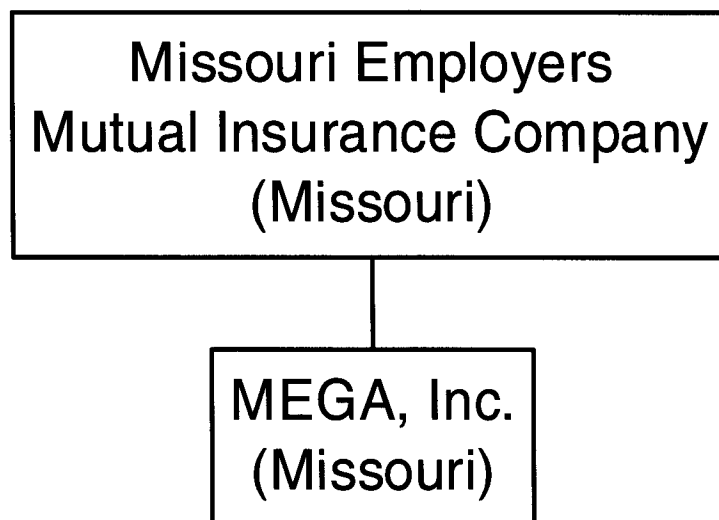
On December 21, 2004 the Company issued a \$20,000,000 surplus note to Sigler & Company in return for \$20,000,000 cash less \$631,000 issuance costs. The note is to be repaid on December 21, 2034. Interest is payable quarterly in arrears at the London Interbank Offered Rate plus 375 basis points. Both payment of the interest and principal is subject to the prior approval of the Missouri Department of Insurance and may be paid only out of the Company's surplus.

AFFILIATED COMPANIES**Holding Company, Subsidiaries and Affiliates**

The Company is a member of an Insurance Holding Company System as defined by Section 382.010 RSMo (Definitions). The ultimate controlling person is the Company.

Organizational Chart

The following organizational chart depicts the Insurance Holding Company System as of December 31, 2004. MEGA, Inc. is a wholly owned subsidiary of the Company.



Intercompany Transactions

The Company and its wholly owned subsidiary, MEGA, Inc. entered into a General Operating Agreement effective February 1, 2001. Under the agreement, the Company appoints MEGA, Inc. as its general agent to place worker's compensation and employer's liability coverages for employers principally domiciled in Missouri with incidental or ancillary locations or operations in states other than Missouri where such operations are staffed or conducted with employees from those states. The Company is the issuing carrier for the Missouri exposures and currently Argonaut Insurance Company serves as the issuing carrier for out-of-state exposures.

The agreement provides that:

- MEGA, Inc. will receive competitive commissions as set forth in the agreement.
- MEGA, Inc. will collect all premiums and fees due the Company and remit the net funds due the Company monthly.
- MEGA, Inc. will maintain current set of books and records for the business written.
- MEGA, Inc. will pay the Company for services provided by the Company as set forth in the agreement.

FIDELITY BOND AND OTHER INSURANCE

The Company is insured on a financial institution bond that provides fidelity coverage with a limit of \$1,000,000. This coverage complies with the suggested minimum amount of fidelity insurance according to NAIC guidelines.

The Company is also insured on policies that provide the following coverages:

Commercial property, including building, personal
property and business income
Electronic data processing
Commercial general liability
Automobile liability
Commercial umbrella liability
Workers compensation and employers liability

Directors and officers coverage
Insurance services professional liability
Employed lawyers professional liability
Employee theft and forgery

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

The Company provides employee benefits typical of the industry including health insurance, dental insurance, vision insurance, life insurance, short and long term disability insurance, a 401(k) and profit sharing plan, a Section 125 medical reimbursement and dependent care plan, paid time off and paid holidays.

The financial statements include provision for the Company's obligations under such plans.

STATUTORY DEPOSITS

Deposits with the State of Missouri

The funds on deposit with the Missouri Department of Insurance as of December 31, 2004 as reflected below, were sufficient in par and market value to meet the deposit requirement for the state of Missouri in accordance with Section 379.098(1) RSMo (Security Deposits).

<u>Security</u>	<u>Par Value</u>	<u>Market Value</u>	<u>Statement Value</u>
U.S. Treasury Note	\$ 400,000	\$ 403,376	\$ 405,885
St. Louis MO Municipal Fin Corp	1,300,000	1,359,787	1,300,345
Total	<u>\$ 1,700,000</u>	<u>\$ 1,763,163</u>	<u>\$ 1,706,230</u>

Deposits with Other States

None.

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory and Plan of Operations

The Company is licensed in Missouri under Chapter 379 RSMo (Insurance other than life) to write all lines of property and casualty insurance. The Company is not licensed to write business in any other states. Currently the Company writes workers' compensation and employers' liability insurance in the state of Missouri. The Company estimates its share of the Missouri market for 2004 at 16%.

Section 287.902 RSMo (Missouri Employers Mutual Insurance Company) provides that preference shall be given to Missouri employers that develop an annual premium of \$10,000 or less. At December 31, 2004 the Company estimated that 84% of its policies generate annual premiums of \$10,000 or less.

The Company has negotiated fronting arrangements with other carriers to provide coverage for the incidental out-of-state employees of its insured. The Company's wholly owned subsidiary, MEGA, Inc., places the coverage written on out-of-state employees with the fronting company. The Company reinsures 100% of the business written by the fronting company.

Under Section 287.915 RSMo (Authorized Agents) any insurance agent or broker licensed to sell workers' compensation insurance in Missouri is authorized to sell insurance for the Company. The Company has approximately 1,475 active insurance agencies.

Policy Forms & Underwriting; Advertising & Sales Material and Treatment of Policyholders

The Missouri Department of Insurance has a market conduct staff that performs a review of these issues and generates a separate market conduct report. The most recent Missouri Market Conduct Examination was completed on May 11, 2001 and primarily covered operations in 2000.

The report did not disclose any issues having a significant impact of the Company's financial position.

REINSURANCE

General

Premiums written during the period under examination were as follows:

	<u>2002</u>	<u>2003</u>	<u>2004</u>
Direct	\$172,491,054	\$170,436,907	\$155,092,846
Reinsurance Assumed	2,082,161	782,813	1,777,998
Reinsurance Ceded	<u>(14,570,244)</u>	<u>(21,850,173)</u>	<u>(19,651,784)</u>
Net Premiums	<u>\$160,002,971</u>	<u>\$149,369,547</u>	<u>\$137,219,060</u>

Assumed

The Company is only licensed in Missouri. As stated above, the Company has negotiated fronting arrangements with other carriers to provide coverage for the incidental out-of-state employees of its insured. The Company's wholly owned subsidiary, MEGA, Inc., places the coverage written for out-of-state employees with the fronting company. The Company reinsures 100% of the business written by the fronting company.

Beginning in 2004, the business was written by Argonaut Insurance Company and reinsured by the Company under a 100% reinsurance agreement dated November 1, 2003.

Ceded

Since inception, the Company has utilized the services of Guy Carpenter, an intermediary, to place reinsurance coverage for its workers' compensation business. Generally, the Company has used multiple layers of excess of loss contracts to limit its liability from large claims. The reinsurance contracts generally provide unlimited statutory coverage in the aggregate or catastrophic

coverage up to \$100,000.00 with excess of loss terrorism coverage.

The Company retained the first \$250,000 loss per occurrence from inception to December 31, 2002, \$500,000 from January 1, 2003 to December 31, 2004 and \$1,000,000 thereafter.

In October 2000 the \$250,000 excess of \$250,000 layer was commuted for claims incurred prior to April 1, 1998 effectively raising the net retention to \$500,000.

From April 1, 1998 through March 31, 2000 the Company effectively reduced its retention from \$250,000 to \$35,000 by reinsuring \$200,000 in excess of \$50,000 under an excess of loss treaty and also reinsuring 30% of the first \$50,000 in loss occurrence under a quota share agreement.

From April 2000 through June 2001, the Company's coverage below the \$250,000 per occurrence loss level was 50% of \$150,000 in excess of the Company's new retention of \$100,000 per occurrence (retention of \$175,000), subject to an aggregate deductible of 2% of GNEPI or gross net earned premium (earned premium income after experience and schedule modifications but before large deductible credits and also reduced by the amount paid for reinsurance inuring to the benefit of this agreement).

Subsequent to June 2001 the Company's retention was \$250,000, and the \$250,000 excess of \$250,000 layer of reinsurance became subject to a 2% loss corridor after the reinsurer absorbed a loss equal to 3.5% of gross net earned premium.

ACCOUNTS AND RECORDS

The Company's financial statements for the period being examined were audited by PricewaterhouseCoopers LLP, Certified Public Accountants. Their opinion dated June 21, 2005 stated "The Company recognizes a liability for producer commissions when the related installment premium is recorded." Statements of Statutory Accounting Principles No.'s 71 and 5 require acquisition costs, including commissions, to be recognized when incurred, which is the policy effective date. If the liability for commissions were recognized as incurred, statutory net income and surplus would (increase) decrease by approximately (\$1,318,000) and \$4,241,000 and \$619,000 and \$5,558,000 for the years ended December 31, 2004 and 2003, respectively."

Since the Company records some of its policies monthly, the commissions also are recorded monthly. Consequently, the Missouri Department of Insurance accepted the Annual Statements for December 31, 2004 and 2003 as filed by the Company. Therefore, no adjustment is proposed as a result of this examination.

Reserves and related actuarial items as of December 31, 2004 were reviewed and certified by John Herzfeld, FCAS, MAAA, associated with the firm of Milliman USA, Inc., Consulting Actuaries.

FINANCIAL STATEMENTS

The following financial statements, with supporting exhibits, present the financial condition of the Company as of December 31, 2004 and the results of operations for the year then ended. Any examination adjustments to the amounts reported in the annual statement and/or comments regarding such are made in the “Notes to the Financial Statements,” which follow the Financial Statements.

There may have been additional differences found in the course of this examination, which are not shown in the “Notes to the Financial Statements.” These differences were determined to be immaterial in relation to the financial statements, and therefore were only communicated to the Company and noted in the workpapers for each individual annual statement item.

ASSETS

	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>
Bonds	\$ 197,063,069	\$ -	\$ 197,063,069
Common stocks	14,479,141	-	14,479,141
Properties occupied by company	3,324,602	-	3,324,602
Cash and short-term investments	21,218,947	-	21,218,947
Investment income due and accrued	1,510,506	-	1,510,506
Uncollected premiums and agents' balances	22,727,848	3,889,140	18,838,708
Amounts recoverable from reinsurers	2,933,850	-	2,933,850
Electronic data processing equipment and software	8,457,853	7,892,453	565,400
Furniture and equipment	618,450	618,450	-
Other assets nonadmitted	1,298,364	1,298,364	-
Automobiles	781,221	-	781,221
Other receivables	470,967	470,967	-
Totals	<u>\$ 274,884,818</u>	<u>\$ 14,169,374</u>	<u>\$ 260,715,444</u>

LIABILITIES, SURPLUS AND OTHER FUNDS

Losses	\$113,066,864
Reinsurance payable on paid loss and loss adjustment expenses	761,113
Loss adjustment expenses	12,481,000
Commissions payable, contingent commissions and similar charges	2,893,508
Other expenses (Note 1)	2,496,388
Taxes, licenses and fees	3,329,478
Unearned premiums (Note 2)	20,728,440
Advance premium	1,632,797
Ceded reinsurance premiums payable (Note 3)	898,488
Amounts withheld or retained by company for account of others	20,940,217
Payable to parent, subsidiaries and affiliates	290,305
Return retrospective premium	250,000
Total liabilities	<u>179,768,595</u>
Surplus notes	\$ 20,000,000
Unassigned funds (Notes 1 to 3)	<u>60,946,849</u>
Surplus as regards policyholders	80,946,849
Totals	<u>\$260,715,444</u>

STATEMENT OF INCOME

Premiums earned	\$141,064,227
Losses incurred	75,079,524
Loss expenses incurred	13,455,115
Other underwriting expenses incurred	<u>45,068,842</u>
Total underwriting deductions	133,603,481
Net underwriting gain (loss)	7,460,746
Net investment income earned	6,638,198
Net realized capital gain or (losses)	<u>2,109,468</u>
Net investment gain (loss)	8,747,666
Net gain (loss) from agents' or premium balances charged off	(2,365,327)
Miscellaneous income	<u>585,300</u>
Total other income (deductions)	(1,780,027)
Net income	<u>\$ 14,428,385</u>

CAPITAL AND SURPLUS ACCOUNT

Surplus as regards policyholders, beginning of year	\$ 44,953,603
Net income	14,428,385
Change in net unrealized capital gains or (losses)	1,169,450
Change in nonadmitted assets	2,573,155
Change in provision for reinsurance	179,000
Change in surplus notes	20,000,000
Cumulative effect of examination changes (Notes 1 to 3)	<u>(2,356,744)</u>
Change in surplus as regards policyholders for the year	35,993,246
Surplus as regards policyholders, end of year	<u>\$ 80,946,849</u>

NOTES TO FINANCIAL STATEMENTS

Note 1 Other expenses \$2,496,388

Other expenses were increased by \$815,000 in order to accrue employee incentive pay for the year 2004.

Note 2 Unearned premiums \$20,728,440

Unearned premiums were increased by \$1,755,943 in order to recognize earned premiums on a pro-rata basis over the term of the policy. The Company had recognized the expense constant portion of the premium for each policy on the inception date of the policy.

Note 3 Ceded reinsurance premiums payable \$898,488

Ceded reinsurance premiums payable were reduced by \$214,199 in order to recognize the reduction in direct earned premiums. Ceded reinsurance premiums are 12.1985 percent of direct and assumed earned premiums.

EXAMINATION CHANGES

Total surplus per annual statement:

Surplus notes	\$ 20,000,000	
Unassigned funds	<u>63,303,593</u>	
		\$ 83,303,593

	<u>Increase In Surplus</u>	<u>Decrease In Surplus</u>	
Assets:			
Total	\$ -	\$ -	
Liabilities:			
Other expenses (Note 1)	\$ -	\$ 815,000	
Unearned premiums (Note 2)		\$ 1,755,943	
Ceded reinsurance premiums payable (Note 3)	<u>214,199</u>	<u>-</u>	
Total	\$ 214,199	\$ 2,570,943	
Net Change	\$ 214,199	\$ 2,570,943	<u>(2,356,744)</u>
Total surplus per examination report:			
Surplus notes		\$ 20,000,000	
Unassigned funds		<u>60,946,849</u>	
Surplus as regards policyholders			<u><u>\$ 80,946,849</u></u>

GENERAL COMMENTS AND/OR RECOMMENDATIONS

None.

SUBSEQUENT EVENTS

None.

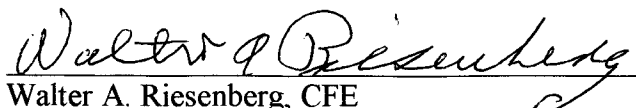
ACKNOWLEDGMENT

The assistance and cooperation extended by the officers and the employees of Missouri Employers Mutual Insurance Company during the course of this examination is hereby acknowledged and appreciated. In addition to the undersigned, Robert P. Jordan, CFE, and Karen Milster, CFE, examiners for the Missouri Department of Insurance, participated in this examination. Jon W. Michelson, FCAS, MAAA, associated with Expert Actuarial Services, LLC, Consulting Actuary, reviewed the reserves and related actuarial items.

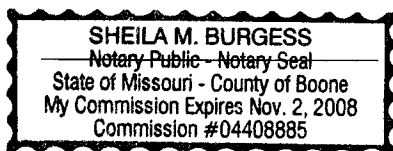
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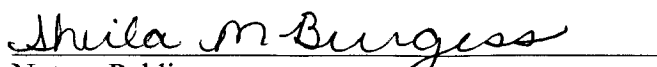
State of Missouri)
) ss
County of Cole)

I, Walter A. Riesenberg, on my oath swear that to the best of my knowledge and belief the above examination report is true and accurate and is comprised of only facts appearing upon the books, records or other documents of the Company, its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined concerning its affairs and such conclusions and recommendations as the examiners find reasonably warranted from the facts.


Walter A. Riesenberg, CFE
Examiner-in-Charge
Missouri Department of Insurance

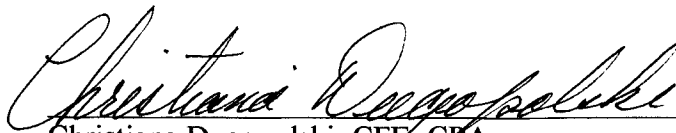
Sworn to and subscribed before me this 21st day of September, 2005.
My commission expires:




Notary Public

SUPERVISION

The examination process has been monitored and supervised by the undersigned. The examination report and supporting workpapers have been reviewed and approved. Compliance with NAIC procedures and guidelines as contained in the Financial Condition Examiners Handbook has been confirmed.


Christiana Dugopolski, CFE, CPA
Audit Manager, St. Louis
Missouri Department of Insurance